WHAT'S *REALLY* IN YOUR FAMILY'S PORTFOLIO?

September 2020

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Benchmarks and indices change over time; sometimes at the whim of market participants and other times as the result of a more intentional design. For example, we just experienced a meaningful change in the composition of the 124-year old Dow Jones Industrial Average with the removal of Pfizer, Exxon and Raytheon in favor of Salesforce, Amgen and Honeywell – a decision made by the editors of Dow Jones. More recently, Tesla stock experienced increased volatility given rumors of an impending addition to the S&P 500. Whether driven by markets efficiently pricing stocks or the visible hand of boards endeavoring to maintain indices that are contemporary and representative, we know that indices will change. For investors, a full understanding of benchmark compositions can help to identify biases in your corresponding investments and provide an important lens to designing a portfolio structured to meet your needs over time.

THE PROBLEM

Benchmarks are essential as family offices weigh opportunity costs, trade-offs and ultimately results. This has become increasingly important amid the dramatic shift from active to passive public equity exposure. According to the Capital Asset Pricing Model ("CAPM"), a capitalization weighted benchmark represents the optimal method for constructing efficient portfolios because the cap-weighting accurately captures the collective wisdom about forward-looking returns. Increasingly, however, what used to be broadly diversified universes of stocks have become more concentrated in certain countries, stocks and industries. This has led some to wonder: Do I really understand what is in my benchmark?

THE SEARCH

Let's take a look at what lies beneath the surface of several popular benchmarks and assess the nature of the changes over time and how those may impact portfolio risk.

THE SOLUTION

With eyes wide open, family offices are able to make risk/reward trade-off decisions based on their unique risk preferences and are able to design portfolios optimized around those risks. It is important to "know what you own" from an investment solution perspective and what will drive return streams. It is also important to understand at a portfolio level where you are taking aggregate risk and whether this conforms to your investment objective.

WHAT LIES BENEATH: INDEX COMPOSITION AND WHAT YOU OWN

Most of our conversations with family offices over the past several months revolve around a few key themes:

- Is the market advance sustainable in the context of a sluggish global economic recovery?
- Do valuations in the US represent a meaningful headwind to forward returns?
- Are we worried about the increased sector and stock concentration in the US equity market?

Our base case remains that global equity markets will likely provide muted returns relative to history given a challenging aggregate earnings outlook coupled with relatively high starting valuations. While that covers the first two concerns, we were intrigued by the third.

The question of index composition is indeed interesting, and we quickly came to the realization that many investors can lack perspective on what they actually own in their passive portfolios, or what has driven out/underperformance of an active strategy relative to an underlying benchmark.

We wanted to provide some perspective based on our own real-time experiences with clients over the past few months regarding the current state of widely held indices and key changes through time. As with most research, this journey began and ended with an appreciation for efficient markets.

ASSESSING THE EVOLVING BENCHMARK LANDSCAPE

Benchmarks, and corresponding indices, are not static. Over time, their changes are driven by both rebalancing or reconstitution at the benchmark level as well as investors who price their forward expectations into today's prices – driving some prices up and others down. History shows us that markets are highly competitive pricing engines and provide meaningful information to investors as supply and demand work to clear that market across securities and sectors.

The wisdom of the collective crowd is an efficient pricing mechanism. Based on evidence from active management, we find that, on average, region or sector bets go uncompensated – there is no risk-adjusted return to be found. That does not mean that there is no skill or alpha available for investors; it simply states the obvious: Skill is rare and difficult to identify ex ante.

Benchmark Risks and Biases

As a result, we have seen massive egress from actively managed equity funds to passive index fund investing, leaving family offices with the certainty that they will get the benchmark return, less fees. The question remains, however: Do investors fully appreciate the differences between popular indices and the risks and biases that are apparent within benchmarks?

This has become a more important question recently for two reasons. First, we seem to be at a fork in the road, as economists struggle to define the future global growth path. Will it be a "U," a "V," a "W" or a square root? Where we sit in the economic cycle, and its resiliency, is critically important as we assess our exposures. Certain indices are more cyclically biased and are poised for performance in the early stages of a durable economic recovery, while others appear more defensive and growth-biased.

The second point is that certain indices, particularly in the US and EM, have become relatively concentrated in a small number of companies within already heavily weighted sectors. The most obvious example of this is in the US, where the top 10 companies in the S&P 500 today have a collective market value of over $8 trillion (with Apple's market cap having recently breached $2T), which represents 29% of the index. This is the highest percentage in 40 years and nearly 7% higher than the beginning of 2020. As mentioned previously, the market is setting the price and is clearly indicating a preference for relative defense amid uncertainty.

Further, there is a bit of Willie Sutton at play here, as the largest technology and communications service firms ("FAANGS") posted year-over-year earnings growth in 2Q of 2% against a decline in S&P earnings of 38% ex-FAANG. So, investors are buying these stocks because that is where the earnings are.

Sector Exposure

Nevertheless, it is instructive to look historically at various factor exposures in the indices over time. We always want to "know what we own." In the global ACWI benchmark, sector exposures are increasingly dominated by technology, healthcare and financials.

This is intuitive given the ACWI exposure to US, at 57%. The financial sector is actually the most consistently large exposure across US, EAFE and EM regions in ACWI (13%, 15% and 18%, respectively) but is clearly more dominant outside the US, which can help to explain some of the performance differentials. However, the absolute and relative performance differences across these regions can be tied more directly to the contrast in exposure to technology (34%, 31% and 15%, respectively).

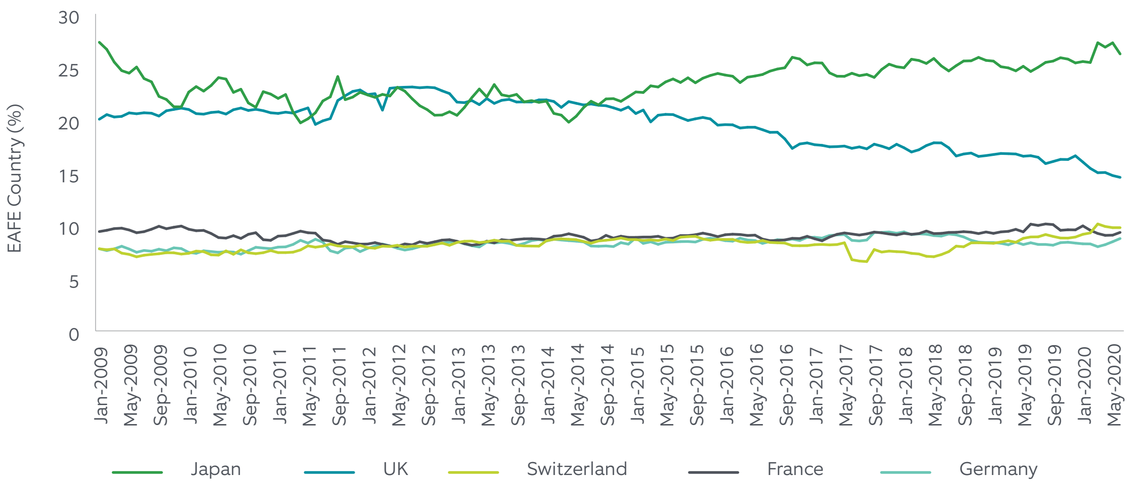
Some of the other differences across regions are notable, with Industrials being a heavy exposure in EAFE, at 15%, and consumer cyclicals a large EM exposure, at 15%. Again, these sector differences have been meaningful and impactful.

Many of these sector differences have driven some family offices to question global diversification and US investors to consider embedding a home country bias into their equity allocations. It is true that, while global equity has performed well in recent years with a 10.5% (annualized) return from January 2009 to June 2020 with moderate risk at 15.6%, the US has clearly dominated the leader board with better performance of 13.8% and similar risk of 15.1%. We can tie the recent dramatic outperformance to one sector: large technology. Looking at the S&P 500, we see that the market return was significantly driven by tech and tech-related stocks, with the 1-, 3- and 5-year contribution of the total return 100%, 77% and 68%, respectively.

Country Allocation in non-US Benchmarks

In addition to sector composition, investors should be mindful of the country allocation within the non-US widely held benchmarks. For example, within the EAFE region, Japan has rebounded to represent more than 25% of the index, while the UK is now less than 15%.

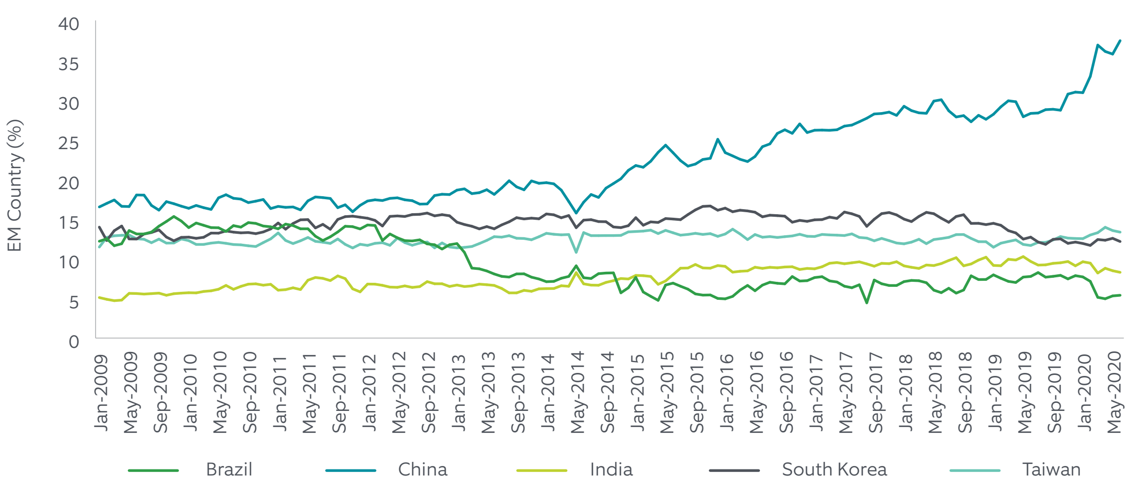
EAFE COUNTRY



Source: Morningstar. Monthly data from January 2009 through June 2020

Within EM, China has raced ahead of its emerging market peers and accounts for a full 37% of the index. Taiwan and South Korea continue to account for 25% of the index. In comparison, Brazil accounted for 12% of the index in 2009 but now accounts for only 5%.

EM COUNTRY



Source: Morningstar. Monthly data from January 2009 through June 2020

These are important differences, particularly as investment committees and families utilize a more top-down approach to allocations, requiring a point of view on the various economies and markets. We also believe that a deeper analysis of the various indices is required.

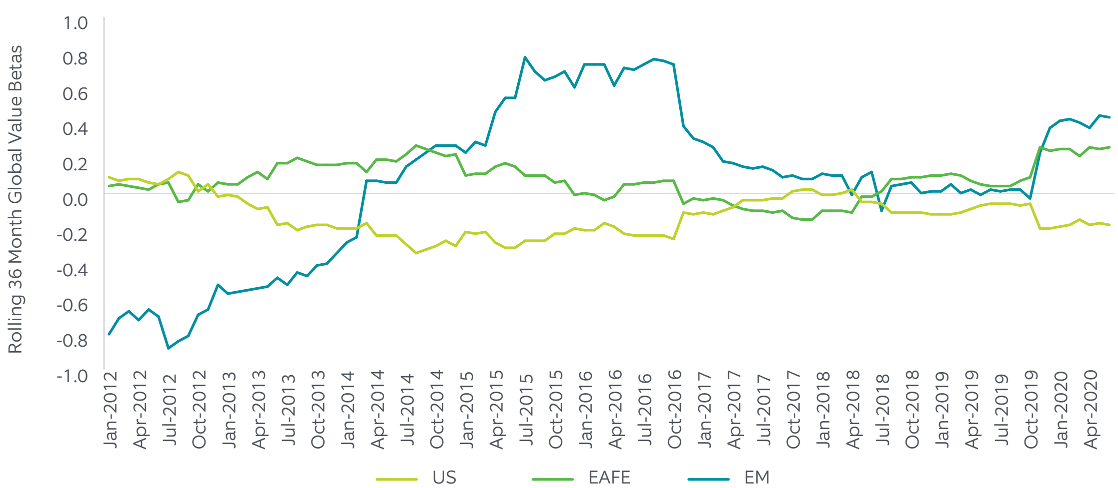
BEYOND SECTORS AND COUNTRIES: RETURN DRIVERS AND RISK

While sectors are the easier framework used to assess portfolio positioning, we prefer to focus on return drivers and risk, which requires taking a factor view.

A US Bias for Growth

The exposures in each underlying benchmark to compensated risk factors like size, value and momentum are important. We observe an expanding growth (negative value) bias in the US that contrasts with EAFE and EM, which have migrated toward a value bias. The underperformance of both of these markets relative to the US parallels the dramatic and prolonged underperformance we have experienced of growth over value.

REGIONAL VALUE EXPOSURE



Source: Morningstar. Monthly data from January 2012 through June 2020

We can see through history that these performance cycles can be long, and this cycle is notable not only in duration but magnitude. Looking at the Fama French data reveals that this cycle has seen the largest underperformance, and for the longest period of time, going back to 1925. This has particularly been the case since 2017.

Questions on Value

Similar to the hindsight reflected in investors rejecting global diversification amid US outperformance, we are hearing more that "value investing is dead," and many are contorting themselves to explain why: the increased use of R&D, impact of the value of intellectual property on tech valuations, etc. Looking at an equal weighted FAANG stock index, we observe a meaningful, persistent and statistically significant growth bias. That's not surprising, of course, but increasingly important as the relative weight of these stocks continues to grow.

The result of the performance differential between growth and value has led to a historically wide gap between the valuations of "expensive" stocks over "cheap" stocks. For example, the Russell 1000 Growth Index has a 34X PE multiple and sells for 10.5X price-to-book, while the Russell 1000 Value Index has a 17.3X PE multiple and 1.9X price-to-book. Valuation is a famously poor market timing tool over short-term time horizons but does include valuable information related to longer-dated returns.

OUR BOTTOM LINE: EYES WIDE OPEN

Our bottom line remains that price matters and that the underperformance of value is likely to reverse over the coming years. As we know, however, there are no guarantees in investments, and risk and return remain related. We worry that investors may not fully appreciate the idiosyncrasies within the regions, like the evolving sector and country exposures that are not static.

Risk factor exposure also migrates over time. Since 2009, very few sectors outside of financials and industrials have had a persistent value tile, while the majority have had major swings between value and growth through time. The benefit to investors of holding the global portfolio is the ability to diversify across all of the publicly available/tradeable compensated risk factors, with no requirement to engage in factor timing.

ACTION STEPS

We have been actively working with our clients on deep portfolio analysis to truly "know what you own" and encourage all to do so. Recognizing the bias in the exposures you may have – sector and country, but also growth, size and value – will be critical in charting a course not only to investment success relative to your risk tolerance, but also to a better understanding of return drivers and performance. For many family offices, we are encouraging them to think about whether a particular benchmark – the S&P 500, for example – is an appropriate benchmark against which to measure "success." The migration of the benchmark over the years to one that is highly concentrated in certain stocks that are very highly correlated is important to recognize. Today's environment calls for a reexamination.

And last, to channel Alexander Pope's "hope springs eternal," we advise our families to take another look at the value factor. This is not a call on the economy, nor is it an attempt to time markets. Simply, we believe that longer term, cheaper stocks will outperform expensive stocks. We also note that the incredible growth on passive index investing as well as the combination of investor overconfidence and the herd mentality have led to a powerful growth (at any cost) rally. The gap in valuation between growth and value, on every meaningful measure, is extreme today, and while mean reversion can take time, it is a powerful force.